

28

The comparative political economy of financial crimes and their enforcement

The case of insider trading

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Introduction: an American crime

When the then-new District Attorney in the Southern District of New York, Preet Bharara, was invited to give a speech under the title 'The future of white collar enforcement: A prosecutor's view' (2010) before the New York City Bar Association in October 2010, observers were expecting a policy speech about the focus on white-collar enforcement following the financial crisis.¹ And that is what they got, only that it was about a topic which had not much to do with the financial turmoil that started in 2008: insider trading. A series of widely publicized investigations and trials duly followed. Two years later, *Time* magazine published a long story on post-crisis enforcement (featuring Mr. Bharara looking icily into the camera under the title 'This man is busting Wall Street'²) that was entirely about insider trading investigations, and without even vaguely reflecting on the fact that insider trading actually had nothing to do with the crisis.

America seems to be obsessed with insider trading. Insider trading scandals are widely covered by the press. The legal treatises, handbooks and journal articles written on it could fill libraries. Meanwhile, in most of the European countries, insider trading remains one of those exotic crimes which are far too rarely prosecuted to attract the interest of legal scholars, let alone criminologists. It occupies a dusty corner of the realm of white-collar crimes.

One of the major reasons for this is apparent: in most of the European countries, notwithstanding their political economy, insider trading *had not even been prohibited* until the end of the twentieth century, and even after the introduction of the insider trading prohibition, it appears to be *less intensively enforced*.³

How can it be that such differences can exist? How come that a financial crime can attain such enormous significance in one country and be not prohibited in another?

This chapter argues that the reason for this lies in the political economy of a financial system and financial regulation. It further contends that political economy can be a valuable tool for a criminologist in the comparative analysis of national and regional differences in the regulation and enforcement of a wide range of regulatory offences.

Proof

453

In this sense, this chapter is also a case study of a theoretical and methodological approach: it analyses economic criminal law and corporate crime in light of their economic, legal and political settings. It puts forward the argument that the political economy of an economic system is a crucial factor in determining how financial crimes are defined by law, which crimes are most likely to be more intensively enforced but also which financial crimes are most likely to be committed.

It argues that financial crimes and their enforcement only ‘make sense’ in a particular economic, legal and political setting. It further argues that this is not only true of the overall economic systems, that is, whether it is based on a socialist or a capitalist logic, where the economic institutions protected by criminal law are fundamentally different, but also of different forms of capitalism.

Capitalism namely has no ‘perfect’ form, but many varieties. The success of a particular form of capitalism depends not on the question of whether its economic and legal institutions comply with theoretical ideals but on whether the functional division of the institutions (including criminal law) that constitute it is stable and effective (Hall and Soskice 2001).

To prove this point, the chapter will compare the prohibition and enforcement of insider trading in two countries with radically different political economies: the United States, where the prohibition originates, and Germany, the biggest economy in Europe, where insider trading had not been prohibited until the mid-nineties. In this comparison, Germany represents a system that is in many ways radically different from US-style capitalism, but resembles many other European economies.⁴

After a brief primer on insider trading and the rationale of its prohibition, the chapter will outline the argument in detail, and will proceed to provide a comparative analysis of the political economy of the US and German financial systems, financial regulation and corporate governance. This will be followed by the analysis of the political economy of the regulation and enforcement of the insider trading prohibition in the second part. The latter will also attempt to answer the question of why insider trading, while considered to be the cornerstone for securities regulation in the US, had not been prohibited in Germany for decades, and why there still remain differences in enforcement intensity.

Why insider trading?

The prohibition and enforcement of insider trading is particularly suitable for comparative analysis, for several reasons. First, while considerable differences exist in the definition and the scope of the criminal prohibition of, for example, embezzlement, corruption or theft across legal systems, most of them have for long had criminal offences in place which functionally speaking prohibits the same kind of activity. Insider trading, however, while having attained enormous significance in one major capitalist economy, the USA, for a long time, had not even been prohibited in most of the other main ones like Germany, Great Britain or France.

But even in the USA, insider trading is a highly contested concept: the necessity, the rationale and the scope of the prohibition are constantly called into question. Thus, insider trading also clearly exemplifies the economic, moral and legal ambiguities that mar many white-collar offences.

However there is one further reason why insider trading is worthy of a more thorough comparative investigation. By delineating legitimate and illegitimate forms of information asymmetry on financial markets, it touches upon the very fundamentals of the capitalist economy, and also positively defines market behaviour. It belongs to the group of white-collar offences (along those defined by competition law, for example) which not only prohibit economic activity damaging to others, but define basic and general rules for how markets should operate (Riles 2011).

What is insider trading and why is it (should it be) prohibited?

Insider trading, at its core, means using inside information (any sort of non-public information capable of moving⁵ the share price of a listed company, either upward or downward) for trading in corporate securities (stocks, stock options or bonds).

The economic rationale behind the prohibition could be manifold. Within mainstream economics it is widely accepted that insider trading is *detrimental to the efficient operation of capital markets*. There are differing views, however, as to why insider trading is harmful.

One theory suggests that insider trading raises the cost of capital by widening the bid–ask spread (Bhattacharya and Daouk 2002).⁶ A second theory puts forward the argument that persistent information asymmetry between insider and outsiders will distort prices. This is the same reasoning as the expectation that used cars have some hidden faults which distorts prices in the used-car market. (Klock 1994). This approach also suggests that widespread insider trading also raises the cost of capital by reducing liquidity: if investors expect that they will be outsiders in a market they might decide to invest elsewhere, which again raises the cost of capital (Bhattacharya and Daouk 2002).

There is a minority view, though, associated by the Chicago School of Economics and mostly voiced by libertarians, which calls the rationale of the prohibition into question. The most important dissenting voice is Henry Manne, who views insider trading as a mode of compensation for corporate managers: the possibility of insider trading is a reward and incentive for corporate managers to innovate (Manne 1966).⁷ A more plausible argument points out that insider trading contributes to the efficient allocation of capital. It helps to move market prices towards the proper price of a security – because other securities professionals would detect insider trading patterns and will react accordingly (Bainbridge 2001).

A radically different approach is taken by those who view the prohibition in light of property rights. In this view the prohibition of insider trading has the very same rationale as the ban on patent infringement or stealing of trade secrets (Bainbridge 2001). Trading on inside information by the corporate insider is thus akin to the infringement on the property rights of the corporation.

Economic arguments, however, concern the question of whether insider trading should be prohibited or not, and do not address the issue of whether insider trading should be criminalized or should only entail civil and/or administrative sanctions.

Scholarship on the criminalization of insider trading mostly concentrates on the issue whether it – along many other white-collar offences – can be regarded as amoral.⁸ There are powerful voices in both the common law (Kadish 1963) and the German legal tradition (Hassemer 2010) which argue for the decriminalization of regulatory offences on the ground that they only constitute *mala prohibita*, conduct prohibited only by virtue of the economic and regulatory context, as opposed to *mala per se*, offences with a strong moral frame of reference (Haines and Beaton-Wells 2009: 221). Others object to the description of insider trading (and other business offences) as morally neutral: Green (2006), for example, sees the rationale of its criminalization in its deeply amoral character involving cheating on the company whose securities are involved and lying to the other party of the transaction (2006: 123–145).

Both the economic and moral considerations about the prohibition and criminalization of insider trading could be explored empirically. The latter involves empirical investigation into the perception of insider trading among laypersons, financial industry professionals, or regulators, law enforcement officials and judges.⁹

This chapter, however, deals only with the former, and concentrates on the empirical context of the economic (and corresponding political and policy) rationale of the insider trading prohibition.

The political economy of finance, financial regulation and corporate governance

This chapter is inspired by three distinct theoretical traditions. One of these is *varieties of capitalism*, which holds that national economies can have radically different arrangements of economic and legal institutions, which are the result of long-term historical developments (Dore et al. 1999). Provided they are established and functioning effectively, they can maintain the integrity of their respective institutional arrangements despite external pressures for change (such as forces of globalization). The equilibrium of these arrangements can also prove to be highly resistant to internal efforts to change them, for example via regulatory reform (Hall and Soskice 2001). Their historical development is to a great extent path-dependent (Deeg 2001). Accordingly, financial markets in the US and Germany are two distinct sets of institutional constellations which differ due to the discrete historical processes that have shaped them.

The other two sources of inspiration are recent studies in economic sociology and social anthropology which study the financial markets in their embeddedness of social and cultural institutions (Granovetter 1985; Polanyi 2001). The difference between American and German capitalism, namely, not only refer to dissimilarities in the macro-level structure and functioning of the US and German financial markets, and to the role they play in their respective national economies. There can also be differences in the way notions about corporate efficiency (Fligstein 1990; 2001), as well as about the ideal form and state of the financial markets, are constructed (Dobbin and Zorn 2005; Zorn et al. 2004). Likewise, cultural representations about shareholding and investment such as the ‘shareholder nation’¹⁰ in the United States shape everyday saving and borrowing practices of households, and with that, a range of other characteristics of the US economy, such as the allocation of capital (Langley 2007).

Finally, this chapter is also inspired by an emerging field in social anthropology (Abolafia 2001; Ho 2011; Zaloom 2006), which sets out to describe financial markets as distinct micro-level social practices, cultural norms, networks of social actors. ‘Wall Street’, in this sense, denotes a particular set of cultural practices, institutional and interpersonal networks and values (Abolafia 2001: 8; Ho 2011: 4). The same applies to Frankfurt as a financial centre.

To provide background for the case study, the following two sections will outline the political economy of the US and German financial system and corporate governance.

Shareholder nation: financial system and corporate governance in the US

The US financial system usually serves as the prime example of a market-based financial system (Hall and Soskice 2001). The most important characteristics of the US financial system are the well-developed, large and liquid capital markets.

The major source of capital for American firms are equities: stocks and bonds. American stock markets are by far the largest in the world. The market capitalization of listed companies stood at 119 per cent of the US GDP in 2012 and the number of companies listed at stock exchanges was 4102 in the same year.¹¹

US households have traditionally been more willing to invest their savings on the capital markets. In 1989, stocks, mutual fund investments and retirement accounts accounted for 48.4 per cent of the savings of an American household, while the proportion of direct bank deposits remained at 28.3 per cent (Kennickel and Surette 2000). Up until the late 1970s securities investments were usually realized through individual brokerage accounts. From the early 1980s, mutual

funds became the major form of non-pension-related securities investment for the American public (Toporowski 2000).

The constant influx of household savings to the capital markets is further ensured by the US pension system, which – though a state-run pay-as-you-go system also exists – is dominated private pension plans or employer-financed pension funds with individual accounts. Payments to the latter two are also invested on the capital markets (Holden et al. 2005).

The foundations for the US federal securities regulation were laid after the Great Crash of 1929 as the part of the New Deal. The Securities Act of 1933, which regulates the primary securities markets (the issuance of securities), and the Securities Exchange Act of 1934,¹² regulating the secondary markets (the buying and selling of existing securities)? The latter also created the Securities and Exchange Commission, the federal securities regulatory agency, which was authorized by the 1934 Act with promulgating rules for the secondary markets. The third most important regulation is the Investment Company Act of 1940, which regulates mutual funds, and the Investment Advisers Act of 1940, which regulates investment advisers.

The priority of these new regulations was to address the information asymmetry that exists between issuers and buyers on the primary markets, and actors on the secondary markets. On the primary markets, the new laws regulated the minimum content for prospectuses, and imposed mandatory registration of every new issuance with the SEC. On the secondary markets, they introduced strict disclosure requirements for publicly traded companies, and strengthened the rights of minority shareholders. All in all, the main aim of the US securities regulation is to ensure that the financial markets are a fair, level playing field for all potential investors. Accordingly, a large part of the regulation was intended to protect the less informed retail investors. For the very same reasons, the laws also contain robust anti-fraud provisions, both for the primary and the secondary markets to prevent various forms of stock fraud, market abuse and insider trading.

The US system of corporate governance regime is complementary to the market-dominated financial system and disclosure-based securities regulation (Cioffi 2006). It knows only one level of control at the firm: the board of directors, which is legally separated from the management, but executive managers have great influence on the selection and election of board members, and usually also serve as members of the board. The weaknesses of shareholder representation is theoretically counter-balanced by the fiduciary duty of corporate directors, but it hardly worked in practice, mostly because the large and liquid financial markets also enable investors to react to management problems with the liquidation of their holdings rather than actively engaging in actual control (Cioffi 2006). This control problem programmed into the system was more exacerbated by the absence of concentrated ownership.

This was, however, beginning to change in the late 1980s, which saw a rapid rise of private investments in the capital markets. While in 1989, 48.4 per cent of the US household assets were kept in stocks mutual funds, and retirement accounts, and 29.3 per cent in deposits, just nine years later, in 1998, these numbers were 71.3 per cent and 19.7 per cent respectively. Yet these investments were different than in the previous decades: instead of direct investment via a brokerage account, they were mostly made through retirement plans and mutual funds (Kennickel and Surette 2000). This, in turn, made institutional investors like mutual funds and pension funds the largest owners of corporate stock and major players on the capital markets.

This rise of institutional investors altered the dynamics of US corporate governance. As their main goal was increasing the returns for their investors, they began to demand more aggressively that the interest of shareholders should come first, and that the major goal for corporate management should be to increase the profit of shareholders. This approach came to be known as the shareholder value approach.

Deutschland AG: the political economy of German finance and corporate governance

The post-war German economic model, alternatively coined as ‘Rheinland capitalism’¹³ or ‘Deutschland AG’ (‘Germany, Inc.’), is usually regarded as the prime example of a ‘coordinated market economy’ (Hall and Soskice 2001).

Germany’s financial system is traditionally bank-centred. As opposed to the market-based system of the United States and the UK, the major source of capital for companies is long-term bank loans (Vitols 2001). This applies to both the (in Germany) traditionally strong small and middle enterprises (SME),¹⁴ which are usually private companies, and the big industrial and manufacturing corporations, the other traditional tier of the German economy, which are typically public corporations.

Most companies have established long-term ties with a single bank (called ‘Hausbank’, or ‘bank of the house’). In the case of the SME sector this bank is usually the local public savings bank or cooperative bank, and in the case of large manufacturing and industrial companies one of the big universal banks.

As the German banking system was large enough to provide enough capital to sustain the post-war economic development, securities markets remained illiquid and underdeveloped. The market capitalization of listed companies in Germany barely hit the mark of 60 per cent of the GDP right before the 2008 financial crisis, and in 2012 it stood at 43.5 per cent.¹⁵ The total value of stocks traded in Germany was 36 per cent in relation to the GDP in 2012, while in the US it was 136.6 per cent.¹⁶ The number of listed companies fluctuated around the 600.¹⁷

Tax system incentives also pushed the companies towards bank loans instead of equity financing. Long-term loans from banks which were often also shareholders, fitted well the profile of Germany’s economy, which has for long been dominated by capital-intensive, incrementally innovating manufacturing. Banks provided ‘patient capital’ with a focus on long-term growth.

Two further characteristics of German capitalism also contribute to the weakness of equity markets in Germany: household saving behaviour and the pension system. German households are traditionally risk-averse, and hold the majority of their savings in bank deposits and insurance policies (Bundesbank 2012). As the latest survey of the Bundesbank finds:

the most widespread assets are current accounts along with savings deposits (78per cent). Endowment life insurance policies come a distant second with a share of 40per cent, followed by savings and loan contracts (36per cent). The predominant type of investment securities is mutual fund shares (22per cent). By comparison, shares (11per cent), bonds (5per cent) and certificates (2per cent) were only directly held by a small proportion of households.

(Bundesbank 2012)

While in the US, private pension plans and company pension schemes provide a constant influx of capital for the equities markets, the major pillar of the German pension system is the mandatory state pension, which is a pay-as-you-go system. Company pension schemes are usually funded by cash reserves (Vitols 2001).

As a result, unlike in the US, equities investments have not been part of the everyday culture for the German middle classes: investment securities are more typical among wealthy and high-income households (Bundesbank 2012).

The existing securities markets were dominated by the large banks, which were involved both in underwriting and trading. Banks were also the largest shareholders of publicly traded companies, especially of the ones with which they have ties as commercial banks. Up to the early

1990s, German securities law remained state law, and the major stock exchanges implemented their own regulatory regimes independently. With the banks being not only the biggest lenders and shareholders of public companies, but also acting as leading underwriters and brokerages, stock markets basically became ‘cartels of large banks’ (Lütz 2000).

As a result of the bank-centred financial system and underdeveloped financial markets, corporate ownership remained concentrated. Large banks and other financial services firms (such as the insurance giant Allianz) owned considerable stakes in big industrial companies, but also in each other. This led to the existence of dense cross-shareholding networks. The cross-ownership also manifested in overlapping supervisory and management board memberships of a closed corporate elite (Beyer 2002; Heinze 2001), also dubbed ‘Deutschland AG’ (‘Germany, Inc.’).

Until the late 1990s, disclosure rules were not stronger for public than for private companies (Becht and Böhmer 1999; Vitols 2004). As a result, company finances remained opaque, which discouraged foreign investors and the larger number of retail investors from entering the equities markets (Heinze 2001).

Under German company law, public corporations have a two-tier board structure: the supervisory board (*Aufsichtsrat*) is separated from the management board (*Vorstand*). The management board is responsible for the day-to-day operation of the company. The supervisory board, which decides upon major corporate policies and strategy, consists of an even number of employees’ and shareholders’ representatives.¹⁸ The supervisory board members representing them are elected by the shareholders at the annual general meeting (AGM). AGMs were usually dominated by large banks and other financial institutions. The voting power of banks was further increased by the legal possibility of them as brokerages voting on behalf of their clients who deposited shares with them.¹⁹ Based on their dominance, banks could elect their representatives to supervisory boards with relative ease. The protection of minority shareholders was also weak.²⁰

In this corporate governance model, the external control of shareholders is internalized (as opposed to external control by market participants) and institutionalized in the form of their representation on supervisory boards. Shareholder representatives on the supervisory boards, however, could have more influence and control over the management than they were granted by law. The combined effects of weak capital markets, concentrated ownership, banking regulation which allowed lenders to become major shareholders, and dense network of cross-ownership led to an ‘insider system’ of control by a close corporate elite with overlapping management and supervisory board ownerships (Deeg 2001; Lane 2004).

This system started to show the first cracks in the late 1980s. By the mid-1990s, radical changes were already undergoing both in German finance and corporate governance. This was partly induced by economic developments and partly by regulatory reforms. In the globalizing finance markets of the early 1990s, Germany appeared secluded and insular. Large German corporations, such as Daimler, Siemens and Mannesmann, however, saw in globalization a chance of expansion and transformation into global conglomerates. They also hoped to tap into foreign capital markets, partly in order to finance their expansion, but also to diversify the sources of their capital.

This interest met the interests of the large private banks. Due to excessive competition in the commercial lending and increasing market saturation large banks were facing diminishing profits from the early 1980s (Deeg 2001). Yet, due to regulatory constraints they remained, though in terms of assets among the largest financial institutions of the world, mostly minor players in the global financial markets. From financial modernization they hoped for the introduction of more sophisticated financial services, which would boost their profits, which in turn they could use to finance a global acquisition strategy which would elevate them to the group of leading global financial institutions.

This shift in business strategies in both large financial institutions and industrial companies led to the gradual winding down of the cross-ownership system (Ziegler 2000). Especially Deutsche Bank led the charge in as it gradually withdrew from supervisory boards (Lane 2004). This also heralded a different approach to share ownership, one that is more shareholder-value-oriented, and more interested in short-term profits.

The German political elite also realized that Germany was heading towards a structural crisis and that it needed financial reforms. This happened in the context of the EU-wide push towards financial liberalization and a more market-based financial system. German financial regulation was reshaped to a considerable extent as a result, and was moved closer to the US/British model.

One of the most important changes was the adoption of federal securities regulation and the establishment of a federal financial supervisory authority (Bundesaufsichtsamt für den Wertpapierhandel, BaWh, later united with the insurance supervisor and renamed Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin). The new federal securities regulation contained many elements of the American model: it brought more robust rights for minority shareholders and strengthened disclosure requirements for public companies, and introduced the insider trading prohibition into German law. The reforms also re-regulated the stock exchanges, ending their regional diffusion and created the Deutsche Börse in Frankfurt as the major German stock exchange. They also introduced a spinoff of the Frankfurt Stock Exchange for tech companies based on the NASDAQ model, the Neue Markt, which was intended to attract more venture capital for new IT and technology companies.

Measures were also taken to encourage the public to engage in equity investment. The pension system was also reformed: a new tier, a private pension scheme was introduced, along with tax incentives that aimed to encourage middle- and high-income individuals to move parts of their savings into individual pension plans (and to the capital markets).

Despite these reforms, German capitalism never really became so market-driven as its American counterpart. The market capitalization of listed companies never really took off following the reform.²¹ In the United States, this was 119 per cent, in the UK 124 per cent in the same year. The number of listed companies also has not changed considerably, and remained around 600 (in 2012 there were 675 companies listed on stock exchanges, compared with 4102 in the United States, 2179 in the UK). The Neue Markt, intended to become the stock exchange for new technology and IT firms, did not survive the burst of the tech bubble and was actually closed down in 2003.

The result of the reform can be described more as the evolution of a hybrid model with elements of both the market-based and the coordinated system. The SME sector was left largely untouched by the changes (Hausch 2004), and so did the public savings bank and cooperative bank sector. Many of the large corporations, such as Siemens, Deutsche Telekom, Volkswagen, and Daimler, on the other hand, underwent radical strategic and organisational adjustments towards a more market- and shareholder-oriented model (Lane 2004). This also applies to the large private universal banks (and also to other financial service companies, such as the insurance giant Allianz). Partly with the help of acquisitions in the US and the UK, the leading private universal banks transformed themselves into global investment banks and major players in global finance. Despite efforts to encourage German middle-class households to invest their savings on the equities markets, savings behaviour also has not changed considerably (Bundesbank 2012).

The political economy of the insider trading prohibition and its enforcement: a German–US comparison

Insider trading is an American crime: it originates in the United States, where it has been prohibited since the early twentieth century, and has been increasingly intensively enforced in the

post-war decades. Meanwhile, insider trading was not prohibited in most European countries for most of the same period, and where it was, it was certainly much less intensively enforced than in the United States (Beny 2002). Now, having explained the dissimilarities in the political economy of German and US finance, let us return to our original question: what can explain these differences, and what role does political economy play in it?

Defending the retail investor: insider trading prohibition in the United States

In the United States, the prohibition of insider trading first evolved in state corporate law in the early twentieth century (Bainbridge 2001: 9). At the time, the prohibition of insider trading was applied only to corporate directors buying shares of their own corporations while hiding facts, which, were they to become public, would increase the share price (Bainbridge 2001: 5). As it was seen as the breach of fiduciary duty of directors towards shareholders, the prohibition only applied to face-to-face dealings, and not to transactions executed at stock exchanges.

The cornerstone of the federal securities regulation, the Securities Exchange Act of 1934, did not explicitly forbid insider trading. Instead, it contained a general definition of fraud committed in connection with securities in section 10(b),²² which also gave the newly founded securities regulator, the SEC, authority to promulgate rules that prohibit specific types of fraud. It was only in 1942, eight years after the Exchange Act came into force, when the SEC adopted Rule 10(b)-5, which now forms the base of the modern insider trading prohibition in most legal systems:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

At the beginning, however, in line with earlier state law, the SEC did not interpret the prohibition as one that applies to impersonal transactions of stock exchanges. This changed only with two now classical cases in the early 1960s,²³ which involved stock market transactions. It was in these cases where another important element of the modern insider trading prohibition was born: the requirement for corporate insiders to disclose the material non-public information they possess before trading ('disclose or abstain rule'). These cases moved the insider trading prohibition from the narrow confines of the director-shareholder relationship of corporate law to a wider setting of securities markets. Though the prohibition has not departed from the basic concept of the breach of fiduciary duty, the SEC constantly and seemingly strategically tried to extend its scope, and apply it to fiduciary relationships beyond the corporate insider-shareholder relation.

While the SEC regularly pursued insider trading cases during the 1970s, the next step in the development of the prohibition arrived in the 1980s, during the years of large corporate mergers and acquisitions. These could lead to unprecedented rises in the share price of takeover targets in a matter of days, making insider trading a much more profitable activity than ever before. It is not a coincidence that most major corporate scandals of the time, such as that of Ivan Boesky and Michael Milken, involved insider dealings.²⁴

The merger-mania of the 1980s also dramatically extended the group of people who can possess inside information: these now included, apart from the ‘traditional’ corporate insiders, investment bankers,²⁵ attorneys,²⁶ journalist²⁷ and even workers in print presses that produced disclosure materials.²⁸ The narrative of SEC enforcement about equal access remained the same, yet it was increasingly difficult to squeeze these people, none of whom were corporate insiders, into any sort of fiduciary relationship. This was accomplished only by the courts extending the scope of the insider trading prohibition to every relationship based on trust which involves the handling of material non-public information: the investment bankers, lawyers and the like were now found to owe a fiduciary duty to their own employers. The theoretical foundation of this extension is provided by the ‘misappropriation theory’ which holds that those who misappropriate, and then trade on, confidential information in violation of a duty of trust or confidence owed to the source of the information can be liable for insider trading.

This trend of extending the scope did not stop when merger mania subsided. In the first decade of the twenty-first century notable cases that further tried to extend the prohibition included professional criminals who bribed employees of a print press which printed an influential business newspaper²⁹ and a hacker who traded on embargoed information he found after hacking into the system of a news service.³⁰

When analysed from a strictly legal point of view, the extension of the scope of transactions prohibited under insider trading rules while keeping them within the original fiduciary-duty-centred framework required increasingly complex legal acrobatics on the side of the SEC and the courts. Yet from the political economy perspective, it made perfect sense.

The leading narrative of the enforcement agencies in most of the cases (presented in court filings and other documents, as well as in public statements) was that the insider trading prohibition was meant to ensure that all investors have equal access to information on the capital markets. In this respect, trading while in possession of non-public information that would affect the share price without the counterparty knowing (or having a chance to know) the same information is akin to cheating, is inherently unfair, and creates inequalities between investors. And if investors think that capital markets are unfair and that insiders have an unfair advantage over outsiders, then these outsiders might decide to invest elsewhere.

And in the context of the political economy of US securities markets this theoretical hypothesis made sense: as most US corporations are financed from the capital markets, the constant influx of fresh capital is vital to the US economy. This explains the US political discourse on ‘shareholder nation’, as well as its many policy implications from tax incentives to regulation of pension plans.

This also makes the prohibition of insider trading (along with other forms of fraud on the secondary markets, such as boiler room fraud) one of the central tenets of the disclosure-centred US securities regulation. And as a considerable part of this capital comes from household savings, it is also crucial to maintain the confidence of these ‘everyday investors’ in the integrity of the capital markets (Langevoort 2009).

The argument had also been made that the strongly transparent enforcement and wide-ranging disclosure rules make also the American capital markets more attractive to both foreign investors and issuers (Coffee 2001).

This mindset deeply influences the self-concept and priorities of US securities enforcement (Seligman 2003). However, the quest to reduce the imbalances of economic power between ‘Main Street and Wall Street’ also has political appeal, which could at least partly explain why insider trading enforcement features so prominently in self-representations of US enforcement agencies.

As discussed in the previous section, the number of US households investing on the capital markets continually rose since the late 1970s; at the same time, however, direct retail investment declined: most households invest via intermediaries – which means that the large institutional investors that reshaped US finance in the last couple of decades now invest, to a large part, American household savings on the behalf of the latter. In the light of these changes, many argued, the ‘Main Street vs. Wall Street’ divide would not make any sense any more (Langevoort 2009). Calls were made to the SEC to abandon its concentration on the protection of the retail investor and reorient its focus on the marketplace now dominated by institutional investors (Langevoort 2009).

An especially controversial issue was the growing practice of corporations sharing inside information with analysts and a select group of major shareholders. This selective disclosure presented ample opportunity for insider trading, potentially harming the retail investors directly invested on the securities markets. Proponents argued, however, that this could shift the balance of power in corporate governance from the management towards shareholders, making shareholder control more effective. The SEC, however, decided to strengthen the disclosure regulation by adopting ‘Regulation Fair Disclosure’ (Reg FD), which made selective disclosure illegal.³¹ These developments, however, do not necessarily weaken, at least in terms of political appeal, the fairness of the market argument, as the large number of households which invested in securities still might feel that they ‘have a stake’ at capital markets and still make them receptive to the ‘even playing field for every investor’ argument.

Insider deals in Deutschland AG: Germany’s hesitant prohibition

German securities laws were not disclosure-oriented as in the American system (Ziegler, 2000), and the protection of minority rights were weak (Höpfner 2001). In the German political economy, however, this was not necessarily a problem, as ownership was concentrated and the large majority of shareholders were also lenders and had long-term vested interest in the corporation.

Insider trading in this ‘insider system’ (Höpfner 2001; Lane 2004) of corporate ownership and control was, of course, also possible, yet it did not pose the same theoretical dangers as in the US system. The need for capital provided by ‘outsider’ investors was low. Illiquid capital markets did not pose the risk of increasing the cost of capital, and the risk of eroding investor confidence was not considerable. The proxy-voting system which enabled large universal banks to vote on behalf of their brokerage customers aligned the interest of the small number of minority shareholders with that of the majority.

This could explain why German securities law completely lacked an insider trading prohibition for the most part of the post-war decades.

A voluntary Insider Trading Guideline was adopted, though, in 1970, which was later revised and amended in 1976 and 1988. The guidelines were binding only for those who submitted themselves voluntarily by virtue of a contract, which was usually a contract of employment. The guidelines defined insider trading only in relation to employees towards the corporation (as in the earliest version of the American prohibition). The only sanction the guidelines foresaw was a disgorgement of profits, and, in the case of refusal, a civil action for breach of contract (Standen 1995). The guidelines, thus, effectively delegated the decision to pursue their own managers and supervisory board members to the corporation, to which, of course, there was little incentive.

It is not a surprise in this light that, even though the majority of German corporations adopted the guidelines, investigations remained scarce – 32 cases altogether between the adoption of the guidelines and the introduction of the legal prohibition (Magnus 1994). Even though

newspaper frequently uncovered suspected insider transactions, these rarely had any legal consequences (Magnus 1994).³²

There are strong indications, however, that the small number of cases does not mean that insider trading was rare. Insider trading, due to the nature of corporate ownership and control, combined with the weak regulation, continued to flourish, and this fact was well-known among foreign investors, who only tended to invest when they were insiders (Pfeil 1996). Insider dealings within the German corporate elite who held overlapping supervisory and management board memberships was widespread and commonly tolerated (Magnus 1994).³³ Due to their presence on supervisory boards, it was not uncommon that even trade union officials were suspected of insider trading.³⁴

It was only in the early 1990s that regulatory reform introduced insider trading prohibition into German law. The prohibition largely followed the 1989 EC Directive on Insider Trading³⁵ (which Germany implemented with a considerable delay). The German prohibition (and the EC directive) does not apply the fiduciary duty-based definition of the American model, just simply distinguishes between primary insiders, that is, anyone who has acquired inside knowledge in his or her official function (be it a corporate executive, a simple employee, an accountant, lawyer or banker), and as a secondary insider, who simply comes into the possession of inside information (for example by chance). All trade by corporate insiders must be reported to the company and to the regulatory authority. The prohibition was supplemented by provisions about ad hoc publicity which required issuers to publish all potentially market-moving information to the investing public by way of electronic media defined in the statute.

The prohibition of insider trading was seen as a necessary prerequisite for attracting foreign investors, and for the increasing willingness of German households to invest their savings in the capital markets. The introduction of the prohibition was intended to convey the message that the traditional view of the German securities markets as an 'insider system' was now over (Cioffi 2007).

Yet the German regulatory authority did not seem to view the enforcement of the prohibition among its priorities. In the first year of the prohibition, eight cases were pursued (BaFin 1995). This number slowly rose over the following years and now fluctuates between 25 and 40 cases each year. Insider trading cases, though from time to time reported in the financial media, rarely receive the frantic publicity that surrounds other corporate scandals.

One of the reasons for this might be that – contrary to the intention of the regulatory reforms in the mid-1990s – the changes to the political economy of German securities markets were, arguably, not substantial. The market capitalization of listed companies has not risen considerably; neither did the number of companies listed. The investment behaviour of German households also has not changed dramatically: capital market investments, though risen, still have a minor share of total German household savings, and this still remains mostly confined to high-income households.

Many cases of insider trading occurred during the German dot-com bubble at the specialized stock exchange 'Neue Markt'.³⁶ This, paradoxically, might have led to decreasing the confidence in capital markets, instead of increasing it.

As opposed to the insider trading related-scandals of the 1970s and 1980s, however, cases now rarely involve prominent members of the corporate elite in leadership position of large financial and industrial corporations.³⁷ This might be explained by the gradual dismantling of cross-ownership networks, which reduced the opportunities of gaining inside knowledge. But this might also indicate the success of the increased transparency and more stringent disclosure requirements the reforms brought about in larger corporations.

All in all, though increasingly pursued, the intensity of the enforcement of the insider trading prohibition in Germany still does not reach that of the US. The political economy of their

respective financial systems can offer some tentative conclusions about why these differences persist. In Germany, banks are still the centre of the financial system, and securities markets remained underdeveloped for most of the post-war decades. The ownership structure and corporate governance this system entailed, though the opportunistic insider trading appeared to be widespread among the corporate elite, did not pose dangers to the integrity of the financial markets and thus to the economy. Retail investors played almost no role in the financial markets. Despite the regulatory reforms and concerted governmental efforts to change it, the latter two characteristics of the German political economy have not changed in the last decades. Insider trading, therefore, though it became prohibited, could not attain the same significance as in the US.

Conclusion: towards the comparative political economy of financial crimes and their enforcement

One of the biggest problems European scholars (and lecturers) of corporate crime are facing is that most of the classic case studies, such as Enron saga, are US cases. They happened not only in a radically different regulatory setting, but also in the unique environment of American capitalism.

This handbook, as the editors detail in their introduction, intends to change this, and provide a foundation for the coordinated research of *European* white-collar and corporate crime. To achieve this goal, it not only contains theoretical reflections, but also several case studies from European countries.

Yet the attention of European white-collar crime scholars cannot move entirely away from the political economy of the US financial system and regulatory environment, and comparative studies that contrast US and European regulation can deliver novel and useful insights, for several reasons. One is that with the US capital markets remaining the largest and the most liquid in the world, they would exert considerable influence on capital market regulation in several other countries for the foreseeable future. International corporations with access to US capital or multinationals that invest in US securities have to adhere to several US regulations, ranging from accounting to disclosure rules. For compliance professionals, be they in Germany, the Netherlands or Spain, US financial regulation is everyday practice.

This also means that corporate crimes are increasingly international in nature. The investigation into the European corporate scandals of the day at the time of the writing of this chapter (autumn 2013), the scandals concerning the alleged rigging of the LIBOR rates,³⁸ is also partly driven by the American authorities. The banks involved are facing parallel investigations and indictments in the US³⁹ in Europe.

The LIBOR rate-rigging scandal also exemplifies how (abusive) local practices and interpersonal and inter-institutional relationships at a global financial centre affect global capital markets. The manipulation of the LIBOR rate was perpetrated by a small group of bankers and traders who knew each other well. The mechanism of setting the LIBOR rate was not based on international regulation or economic modelling, but on a practice that developed in the same gentlemanly, clubby atmosphere⁴⁰ of the pre-globalized City in London in the 1950s (where insider trading was also a fact of life⁴¹). Later, the markets changed and with them, the incentives of the banks involved in rigging the rate, yet the practice remained the same enabling the fraud to take place with staggering global implications.

The internationalization, of course, applies not only to the US–European comparison. Comparative studies of white-collar and corporate crime *within Europe* could also gain new insights if informed by political economy. Financial markets and corporate governance still radically differ in European countries, and so does corporate crime.

It is customarily assumed, for example, that the differences between corporate governance in the US and in Europe, especially the two-tiered board structure compulsory above a certain size in most European company laws, have prevented accounting scandals of the magnitude of Enron from happening, or at least from going on so long in Europe (e.g. Coffee 2005).

Yet while Enron-type cases arguably never happened in Germany,⁴² they did occur (such as the Dutch Ahold scandal, or the Parmalat case) in other European countries where two-tiered board is also compulsory. In exploring what other factors contributed to these differences, the comparative analysis of political economy and corporate governance could also pay a role. It is possible, for example, that Germany could be considered different not simply because it applies a two-tier structure, but due to the fact organized labour and representatives of the biggest lenders sit on supervisory boards – a fact that is rooted in the unique German political economy.

Another possible field of research is the how differences in the political economies of Eastern European and Western European countries affect white-collar and corporate crime. How and in what respect is corporate and white-collar crime different in a nascent capitalism from in an established one?

One of the most important repercussions of globalization is that the conflicts between political economies described in this chapter now might play out *within firms*. This intra-firm conflict of political economies can create compliance problems and distinct opportunities for corporate crime. The alleged rigging of the LIBOR rates can again serve as a good example.

In the course of the 1980s and 1990s traditional European financial institutions, such as Deutsche Bank or the Dutch cooperative bank Rabobank, decided to expand into global finance. To reach that goal, they founded subsidiaries in American and Asian financial centres, or used their financial might to buy up financial institutions operating there. Yet this move not only created a range of compliance issues, but also greatly affected their business practices and institutional cultures. Whether the long list of corporate scandals that mar Deutsche Bank can be attributed to its transformation⁴³ from a traditional German bank into a Wall Street giant and global financial institution – as it is widely discussed in the German financial media⁴⁴ – might deserve a proper scholarly investigation.

Whether the now indicted Rabobank employees responsible for submitting the LIBOR rates⁴⁵ (sitting in Utrecht in the Netherlands) could be regarded, in terms of market and institutional culture, Dutch or London city bankers, is another facet of the LIBOR scandal which might be interesting for criminologists to explore, and where the political economy of a particular marketplace might also come to play a role.

Another possible field of research which can benefit from the political economy perspective is the study of cross-border corporate crime. International tax evasion and tax fraud, for example, is a crime which by nature capitalizes on differences in regulatory frameworks and political economies. Offshore finance, for instance, and its role in financial crimes, cannot really be understood without considering the political economy of offshore financial centres.

The political economy framework could, thus, contribute to our understanding of why and where European corporate and white-collar crime is different.

Notes

1 The Federal District Attorney's office in the Southern District of New York, which has jurisdiction over Manhattan, is probably the single most important law enforcement office in the US in white-collar and financial crimes. <http://www.nycbar.org/44th-street-blog/2010/10/21/preet-bharara-on-the-future-of-white-collar-enforcement-a-prosecutors-view/> (accessed 15 September 2013).

2 Calabresi and Saporito (2012).

- 3 Enforcement intensity is hard to measure. In this chapter, when talking about enforcement intensity, I do not only refer to quantitative, 'hard' (number of investigations; indictments and judgments annually), but also qualitative 'soft' indicators (such as the self-representations of enforcement agencies towards the public, in budgetary negotiations, parliamentary oversight bodies, etc.). For more on these methodological considerations see Györy 2014.
- 4 It is important to note that the widely cited division between Anglo-Saxon and social market (continental) capitalism (Albert 1993; Hall and Soskice 2003) does not apply here: Great Britain was just as inert to introduce (and then enforce) an insider trading prohibition as the other European countries (Barnes 2011; Nelken 2007: 758). Our hypothesis, elaborated below, is that the main reason for the ascent of the insider trading prohibition in the United States is to a great extent due to one of the few characteristics British and American capitalism do not have in common: the large base of retail investors.
- 5 This capability of moving the price of a security is called the 'materiality' of the information. The question as to what counts as material information is one of the most notoriously vague points of the regulation.
- 6 The bid-ask spread is the spread between the price at which a market maker buys and at which it sells a particular security. It is the bid-ask spread via which a market maker makes its profit. It was found that in the case of suspected insider trading this bid-ask spread is wider, increasing the cost of capital (Bhattacharya and Hazem 2002).
- 7 This argument, however, obviously falls short in light of the fact that insiders can make money not only on good news, but also on bad news.
- 8 Even though an economic argument could be made for the more powerful deterrent effect of criminal sanctions, this has not been done to my knowledge in the context of insider trading.
- 9 For the empirical study on laypersons' perception of insider trading, see Green and Kluger 2012. For a qualitative study of attitudes among regulators and law enforcement officials and prosecutors, see Györy 2014.
- 10 That is, that it is almost a civic duty to invest household savings on the capital markets.
- 11 <http://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS/countries/1W-DE-US-XC-NL?display=default> (accessed 15 September 2013).
- 12 The 1934 Act only regulated stock exchanges in its original form. This was later amended so that it applies to over-the-counter (OTC, meaning: not on stock exchanges) sale of stocks. In 1963, the law was amended again and now it applies to the sale of any securities (irrespective whether it is listed or not).
- 13 The term was coined by the French political economist Michel Albert (Albert 1993).
- 14 German SMEs (*Mittelstand*) are usually export-oriented, highly specialized, capital-intensive engineering or industrial companies, manufacturing complex products for global niche markets on which they are usually dominant players or even enjoy monopolies. SMEs are responsible for almost 40 per cent of the German GDP (Gürtenberg 2012).
- 15 <http://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS/countries/1W-DE-US-XC-NL?display=default> (accessed 15 September 2013).
- 16 <http://data.worldbank.org/indicator/CM.MKT.TRAD.GD.ZS/countries/1W-DE-US-XC-NL?display=default> (accessed 15 September 2013).
- 17 <http://data.worldbank.org/indicator/CM.MKT.LDOM.NO/countries/DE-US?display=default> (accessed 15 September 2013).
- 18 In the case of companies employing 2000 individuals and upward. The balance was, though, lightly tilted towards the shareholders as they have the right to elect the president who has two votes in case of an even vote.
- 19 This is proxy voting system was called the *Depotstimmrecht*.
- 20 Though their rights were formally relatively strong, courts tended to side with the larger shareholders (Heinze 2001).
- 21 See note 11.
- 22 15. USC. § 78j. This reads: '10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange [...] (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered [...] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.'
- 23 *In Re Cady, Roberts & Co.* 40. SEC. 907 (1961) and *SEC v. Texas Gulf Sulphur Co.* 401. F.2d 833 (2d. Cir. 1968).

- 24 The latter insider trading case also inspired one of the most prominent cultural representations of Wall Street greed: the arbitrageur Gordon Gheeko, who makes his money on insider trading in Oliver Stone's movie *Wall Street*.
- 25 *United States v. Newman* 664 F.2d 12 (2d. Cir. 1981).
- 26 *United States v. O'Hagan* 521 U.S. 642, 655 (1997).
- 27 *Carpenter v. United States*, 484 U.S. 19 (1987).
- 28 *Chiarella vs. United States* 445 U.S. 222 (1980).
- 29 *SEC v. Anticevic et al.* 05 Civ. 6991 (KMW) (S.D.N.Y.).
- 30 *SEC v. Dorozkho* 574 F.3d 42 (2d Cir. 2009).
- 31 <http://www.sec.gov/rules/final/33-7881.htm> (accessed 15 September 2013). The arguments clearly follows the 'integrity of the market' rhetoric.
- 32 Magnus compiled a list, which also includes references to the press articles that uncovered them. The compilation reads like the who's who of the German economy: managers of supervisory board members of Daimler Benz, RWE, Bayer, Audi, Neckermann, AEG, and Springer were all suspected of insider trading transactions in this period.
- 33 This very much resembles the situation in the City of London (Britain was also hesitant in incorporating the insider trading prohibition into its law), where insider trading was considered to be one of the perks of being a trader (Clarke 1990: 162).
- 34 The then-head of IG Metall, the largest German labour union, Franz Steinkühler, was forced to resign in 1993 after he used his inside knowledge as the member of the supervisory board of Daimler AG to tip members of his family off about an impending share swap.
- 35 EC Directive 89/592, 1989 O.J. (L334) 30.
- 36 Insider scandals concerned some of the most celebrated companies of the era, such as the IT companies Biodata AG, IXOS AG and Heyde AG, as well as media businesses such as Viva Media, Brainpool and Kinowelt.
- 37 Own compilation of data based on BaFin annual reports and case files.
- 38 LIBOR (London Interbank Offered Rate) is an average interest rate at which major banks borrow from each other in London. The rate is calculated every day from submissions from a select number of banks, which report the rates they are borrowing, or expect to borrow, from other banks. Many interest payments around the world (such as mortgages, student loans, etc.) are pegged to LIBOR.
- 39 The US jurisdiction is based on the fact that the interest payment of several types of loans and mortgages are based on the LIBOR.
- 40 'The rotten heart of finance: A scandal over interest rates is about to go global.' In the *Economist*, print edition, 7 July 2012. <http://www.economist.com/node/21558281>.
- 41 See note 37.
- 42 At least in magnitude – there were some notorious cases in Germany during the 1980s and the 1990s with similar characteristics to the Enron case (such as the scandal involving the companies IBH Holding and Balsam AG), but these concerned relatively small SMEs with unitary/family ownership where predatory pricing or aggressive acquisitions were conducted without proper strategy and funding, and false accounting was used to cover up the losses caused by them. But the financial loss caused was negligible compared to Enron, and the practices were relatively quickly uncovered.
- 43 A fact that is acknowledged by a curious CEO duopoly: the former New York and London investment banker Anshu Jain (who does not speak German but used to run one of the most profitable operations on Deutsche Bank in London and New York) represents the Anglo-Saxon-style investment banking arm, while Jürgen Fitschen, a German banker, runs the traditional core businesses (such as corporate lending). For the political and economic context of this transformation, see the section on the political economy of German finance in this chapter.
- 44 These scandals include investigations into fraud connected to trading in emission certificates, cooking the books to avoid government bailout, and large-scale tax evasion. Deutsche Bank also featured in many crisis-related cases due to its involvement in the US mortgage market, and is (as of autumn 2013) also under investigations for rigging the LIBOR and EURIBOR rates. <http://www.spiegel.de/international/business/deutsche-bank-reputation-at-stake-amid-a-multitude-of-scandals-a-873544.html> (accessed 15 September 2013).
- 45 http://dealbook.nytimes.com/2014/01/13/three-former-rabobank-traders-charged-in-libor-case/?_php=true&_type=blogs&_r=0 (accessed 15 September 2013).

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